THE REORGANIZATION OF RAILROADS.

The consolidation of the leading trunk line railways during the last two years, a movement which seems to promise at no distant date the union of the entire railway system of the United States under a single management, draws attention to the thorough-going readjustment of the securities of doubtful roads which paved the way for the consolidation. The panic of 1893 revealed the precarious condition of many of the largest systems in an unparalleled series of bankruptcies. At one time 52,000 miles of railway were in the hands of receivers. The searching examination of their affairs which followed their efforts for rehabilitation revealed the facts that the bankrupt roads were greatly overcapitalized, that their bonds were improperly secured, that their traffic agreements and leases were often a burden rather than a help, and that in many cases they had been badly, even fraudulently, managed. With these facts before them, the financiers to whom the task was committed by the bondholders set about the work of reorganization.

The reorganization of a bankrupt railroad is a settlement of the claims of the different parties in interest on such a basis that the property can be released by the court and again managed as a going concern. Reorganization does not imply a sale for the benefit of creditors. The conflicting interests of a great railway system are so many and various and the complexity of the system is so great, being made up as it is of numerous parts which have been slowly welded together in the growth of the system, divisions, branch lines, subsidiary companies and terminal companies, each branch and section, moreover, having been long since covered with mortgages of different age and degree, while the terminals are represented by a separate issue of bonds, the rolling stock by another, and the whole covered over by a general mortgage, the complexity of such a structure, to

repeat, is so inextricable, that an attempt to carry out in literal detail the provisions of the mortgages would be not merely expensive and inconvenient, but unjust and unlawful. It is expensive and inconvenient because, for any class of bondholders to purchase the road outright, involves a settlement of the claims of other creditors on a cash basis, a transaction enormously costly and correspondingly tedious; whereas to attempt a foreclosure of branch line mortgages or sectional mortgages, whose security is valuable because of the fact that they are integral parts of a large railway system—to foreclose and take these separate pieces of railroad out of their connection with the system as a whole, would greatly impair their value. It is unjust, because the value of a railroad at a forced sale, when it is covered with the stigma of default and under the cloud of bankruptcy, when, moreover, as is always the case, its earnings are far below their normal level, and when the demand for securities from the public is weak and uncertain, does not represent its real value. A foreclosure sale is unjust to stockholders and junior bondholders in that it would seriously impair, if indeed not entirely destroy, the value of their securities. It would force a sale under unfavorable conditions at a time when purchasers are not to be had, and when the property is unduly discredited and depreciated.

A foreclosure sale is manifestly impossible, but the interests of the security holders and of the financial world point to a speedy settlement. The road must be placed upon its feet with the least possible delay. So long as its affairs are unsettled, the values of its securities, with the exception of certain divisional and terminal bonds which are too well secured to be in any way affected, are abnormally low, lower even than the value which the diminished earning power of the road would naturally assign them. This unnatural depreciation applies particularly to all junior bonds and to the stock, the securities, in other words, which will naturally be disturbed in a reorganization. The uncertainty as to

their future greatly depresses their value. Those persons whose capital is invested in these discredited securities are unable to realize on their investment for fear of utterly breaking the weak market, and increasing the weight of losses which are already severe. Banks and trust companies have taken such stocks and bonds as collateral, and, pending a settlement of the value of these securities, their loaning power is to this extent reduced. The banks are unable to sell the collateral for fear of loss, and without a reorganization the loans which they have made on the basis of those securities cannot be paid. All interests are equally concerned to reach a speedy reorganization of a bankrupt corporation. Unless some attempt is made to treat some interest unfairly, the operation is quickly concluded. The welfare of every interest points to an amicable settlement which shall preserve the integrity of the system, and equitably apportion between the stock and bondholders the losses which have been sustained by the road. The courts have always taken this view of the matter, and have sometimes gone so far as to recommend to conflicting interests that they make haste to arrive at a settlement of their difficulties in order that the receivers might be discharged.

Objects of Reorganization.

The objects of reorganization are (1) to pay off or fund the floating debt; (2) to provide funds for betterments and for working capital; (3) to reduce fixed charges within a conservative estimate of net earnings.

The payment of floating debt is of first importance. A large floating debt is a constant menace to the safety of any railroad. The Reading emerged from a receivership in May, 1883, under a plan of reorganization which did not make adequate provision for the floating debt. The result was that in June, 1884, the road was again in the hands of a receiver. The maintenance of a large floating debt is also a

heavy expense because of the necessity of frequent renewals, which must often be met at a time of financial stringency. The Reorganization Committee of the Atchison, Topeka & Santa Fé, in the report of 1895, stated that during the five years preceding the road had paid over $1,100,000 in discounts and commissions to secure the renewal of $9,000,000 of guarantee fund notes. As an unsecured claim, floating debt is inferior to bonds, except in so far as it represents arrears of wages and payment for supplies. Floating debt, however, is usually very well secured. It represents advances by bankers, trust companies, or large individual capitalists, and is fully secured by collateral which, in its turn, is secured by property indispensable to the operation of the system. The Reading Railroad Company in 1892 deposited $12,000,000 of collateral to secure $2,000,000 of loans. The holders of floating debt are thus in a position to demand full recognition. If their claims are not paid they can either present the bonds which they hold as collateral to be taken care of in the reorganization, or they can make trouble by selling these securities, and injuring the credit of the company which is being reorganized. Moreover, the trustee of collateral bonds is usually authorized, in case of default, to apply the income from the collaterals to the payment of the interest due, and if any surplus remains to apply it to the principal payment if a forced sale of these securities seems inadvisable. The first object of every reorganization is therefore to provide for the floating debt.

The physical condition of the road next demands attention. Road-bed, track, bridges and equipment have been allowed to deteriorate before the failure, money may have been taken from betterments to apply to dividends, and the facilities of the road are entirely inadequate to accommodate the traffic which it would otherwise secure. While the receiver is in control he usually finds it necessary, in order to keep the road in operation, to make large expenditures for betterments. Much, however, still remains to be done

in the same direction before the railroad can be considered safe. The Reorganization Committee of the Northern Pacific Railroad estimated that at least eight million dollars must be spent on the road in a very short time. If the new arrangement is to be permanent, if the road is to be secured against future disaster, and if it shall gain its full share of a growing traffic, it must be put in the very best physical condition. The earnings of the Chesapeake & Ohio Railroad, which was reorganized in 1888, and has since been managed by Drexel, Morgan & Company, who financed the reorganization, have been largely increased as a result of the heavy expenditures upon road-bed and equipment which were provided for in the readjustment. It is not necessary that the entire amount necessary for this purpose should be raised at once. Nay, more, if the earnings of the road improve, these special appropriations may possibly not be required. Some guarantee, however, there must be for this purpose if the reorganization is to be successful.

The reorganization managers should also provide that the net earnings of the system, on a minimum estimate, should insure a good margin above fixed charges. Unless this is done, at the next season of trial, net earnings may again fall below interest requirements, and another surgical operation will become necessary. It is not necessary, and it is never provided, that fixed charges should be so much reduced as that an estimate of net earnings, based on present conditions, would assure the immediate payment of dividends. Such a course would be unfair to bondholders. If reviving business increases earnings to the point of dividend payment, that is the good fortune of the stockholders; but the bondholders cannot in reason be asked to submit to a greater reduction in their claim than is sufficient to enable the road, out of its net earnings, to pay interest and provide for working capital, renewals, and betterments. It is customary to take the net earnings of years preceding the default as the basis of reorganization. This is, however, compared with the more

favorable figures of former years in estimating the ultimate loss which must be sustained.[1]

Methods of Reorganization.

The first step in carrying through a plan of reorganization is usually the formation of committees to represent the owners of different classes of bonds and stocks. This may not be necessary. The receivers or the directors may themselves formulate a plan of reorganization, or they may appoint a committee to formulate such a plan, to which they invite the assent of the security holders. If the plan proves satisfactory, it may, without further proceedings, at once be put into effect. It is seldom, however, that this method of settlement can be adopted. Holders of different classes of securities which are unequally burdened by the plan of reorganization, although the terms proposed may be as fair to all interests as any subsequently obtained, are unlikely to consent to any plan which they have had no hand in framing. The formation of committees is sometimes delayed until a preliminary plan can be considered. If this proves unacceptable, the disaffected interests proceed to organize in self-defence. Particularly when the bonds are held abroad, has it been usual for protective committees to be appointed to represent the interests of English, Dutch and German investors. These committees are appointed in different ways. The simplest plan, as above noted, is for the receivers or directors to appoint a committee to draft a plan. Such a committee, however, represents no interest and is merely advisory. The first reorganization plan of the Erie Railroad in 1893 was proposed by a committee appointed by the receivers, and the reorganization plan of the Wabash road in 1886 was proposed by directors. It is not often, however, that a plan thus proposed

[1] The Northern Pacific committee, in one instance, refused to consider, in their estimate of net earnings of the previous year, the sum of $363,000, a loss which they claimed had been due to "exceptional circumstances," altogether unlikely to recur.

secures the consent of the creditors. Another method is for a meeting of bondholders to be called for the purpose of appointing a committee. This was done in the case of the Richmond and West Point Terminal in 1892. Such a committee is temporary, and, as a rule, contents itself with proposing a plan for the consideration of other interests. But it is when dissatisfaction with proposed plans arises, that bondholders and stockholders hasten to unite. The method now usually employed is for large individual holders to constitute themselves or their representatives a committee to take charge of the interests of a particular class of securities, and to invite creditors or stockholders to signify their consent to this arrangement by depositing their securities with some designated agent. If a majority of the securities are thus deposited, the self-constituted committee becomes representative, and is legally entitled to act in the reorganization proceedings. [1]

Stockholders' reorganization committees are of more seldom occurrence; and are resorted to only when a proposed plan of reorganization is so manifestly unfair as to give the injured party a standing before a court. Thus, in the first plan for reorganizing the Texas & Pacific Railroad in 1886, which was brought forward by the Gould interest, it was proposed that the stockholders pay an assessment

[1] On June 10, 1885, certain holders of the first mortgage bonds of the New York, West Shore & Buffalo Railroad issued a circular, in which, after setting forth the danger that the other creditors of the road would secure themselves, to the prejudice of the bondholders, they made the following proposition: "It becomes imperative for the bondholders, therefore, to combine and take immediate action to protect their own interests. To that end, the undersigned—themselves bondholders, and with no other interest in the property, directly or indirectly, except as such—constitute a committee for the purpose of enforcing all the rights of the bondholders under the mortgage, and of securing to them ownership of the property which it covers at the earliest possible date. That the efforts of the committee will meet with vigorous opposition is evidenced by the repeated threats of those whose representations induced the purchase of the bonds that foreclosure of the mortgage can be delayed for many years. But the committee, satisfied that to foreclose the mortgage and take the property is the only way now open to the bondholders, is ready to accept the issue and undertake the work." A majority of the bonds were placed in the hands of this committee and it forthwith became representative.

which practically amounted to two-thirds of their holdings. The stockholders immediately placed their interests in charge of a committee which co-operated with other committees representing different classes of bonds, and succeeded in reducing the assessment from 66⅔ per cent to 5 per cent, which later was generally considered to be a fair amount. As a rule, however, the stockholders have had no opportunity to make their slender claims felt in reorganization proceedings.

The next step in the reorganization is the formation of a new company in which is vested, after foreclosure sale, such portions of the property of the old company as it is thought wise to retain, and which either assumes the obligations of the old company in their original form, or secures such modifications and reductions in their amount as are necessary to the success of the new company. In the conditions of exchange of the securities of the old company for those of the new the objects of reorganization can be attained. This exchange of securities serves a two-fold purpose. It makes possible a concentration and simplification of the system by uniting branch line and terminal securities, car trust certificates, equipment bonds and other heterogeneous fragments of investment under single issues, which are more easily managed, better secured, and of higher value than those which they displace and it affords a basis of settlement with those interests whose securities are disturbed by the reorganization.

Consolidation of Securities.

An illustration of the effect of reorganization in unifying the securities of a road is afforded by the Atchison reorganization of 1896, the results of which are presented in the following table :

List of securities before organization.	List of securities to replace them.
Chicago & St. Louis, first mortgage 6's .	Chicago & St. Louis, first mortgage 6's.
Guarantee Fund Notes 6's.	
Equipment Trust, series A	Four per cent general mortgage.
Equipment lease warrants.	
Miscellaneous unconverted bonds. . .	Four per cent adjustment bonds.
General mortgage 4's.	
Second mortgage "A" 4's.	Preferred stock.
Second mortgage "B" 4's.	Common stock.
Income bonds.	
Capital stock.	

Not only are the securities which are disturbed in the reorganization consolidated and unified, but provision is further made for the creation of sufficient securities to be issued in exchange for all undistributed divisional bonds as they come due. The advantages to be derived from this simplification of a railway system are set forth in the circular issued by the reorganization committee of the Northern Pacific Railway. The property of this company consisted of a railway system of 5,706 miles, a land grant of 43,000,000 acres, and sundry bonds, stocks and accounts representing interests in terminal, express, coal and navigation companies. This property, before the reorganization, was represented by fifty-four corporations which had issued $380,000,000 of stocks and bonds. The circular continues:

"As it now stands, the system, in its form of incorporation and capitalization, is a development without method or adequate preparation for growth. Scarce any single security is complete in itself. The main line mortgage covers neither feeders nor terminals. The terminal mortgages may be bereft of their main line support. The branch line bonds are dependent upon the main line for interchange of business, and the main line owes a large part of its business to the branch lines."

It was evidently a great advantage to this road to have its various parts firmly united under one set of securities, for which the entire system, complete in every part, with all its

property under its immediate control, stood sponsor. By this reorganization, moreover, a sinking fund provision, attaching to the land-grant bonds, which, by requiring the payment of a fixed proportion each year, rendered the life of each bond uncertain, and seriously depressed the value of the entire issue, while, at the same time, injuring the company in those years when it was necessary to sustain the sinking fund out of the net earnings. The Erie Railroad offers another example of an advantageous union of conflicting interests by means of a reorganization. The Committee of Reorganization remarked as follows:

> "The Erie System is made up of the lines known as the New York, Lake Erie & Western, the New York, Pennsylvania & Ohio, and the Chicago & Erie roads. These two latter are operated by, or for the Erie, upon the guaranty that a fixed proportion of their gross earnings shall be paid without regard to the actual interests of the business. This arrangemement is inherently weak and develops a conflict of interests between three companies that ought to be close allies; and it also checks development and improvement (which are especially necessary in respect to the N. Y., P. & O.) as expenditures for such purposes are beyond the ability of the Erie, which has no *real* proprietary interest in these lines and no means of securing reimbursement for betterments upon them. The permanent removal of these troubles is most desirable. In order to remove them, and to establish the community of interests above referred to, the annexed plan proposes to consolidate or otherwise unite the three corporations. The new company will, so far as practicable, be vested with direct ownership of the various properties, comprised in the system by avoiding the necessity of keeping up the separate existence of a large number of the subsidy companies controlled by the present company."

A more important use is found for the new securities in exchanging them for the disturbed securities of the old company. These securities may be disturbed in various ways—by assessment, by conversion into other claims of inferior lien, by reduction of interest, and by reduction of principal. Most important of these changes are those resulting from assessment, and from the conversion of junior

mortgages into claims upon profits. The nature and results of assessment will first be considered.

Assessment upon the Stockholders.

In every receivership, large sums must be raised to lift the bankrupt out of the mire of difficulty. Floating debt has accumulated and must be paid. Unpaid interest has piled up to disheartening heights, and the expenses of the reorganization are by no means small. This is to say nothing of the expenses of betterments and repairs, which, indeed, as will be presently shown, can be spread over a long period, and dealt with in different fashion. The cash requirements of the Baltimore & Ohio in 1896 for unpaid interest were $4,565,000, for car trust certificates, receivers' certificates and other obligations, $19,192,000, and for floating debt, immediate improvements, equipment, working capital of the new company and reorganization expenses, $12,334,000, making a total to be raised of $36,092,000. The managers of the Erie reorganization of 1895, had to provide for reorganization first lien bonds $2,500,000, for collateral trust bonds $3,344,000 and for floating debt and equipment trust notes, $13,500,000, a total of $19,344,000.

This money can be raised in two ways—by assessment upon the different interests concerned, according to the degree to which the nature of their securities renders them liable to imposition, and by the sale of the general mortgage bonds of the company. In rare instances, also, securities already held in the treasury have been sold. Most of the floating debt consists of short time loans, secured by bonds and stocks, of which the company is still the owner. It might seem that this property could advantageously be sold to pay the debt which it secures. A large amount of floating debt has to be paid. This floating debt is secured by collaterals, whose market value is sufficient to pay the obligations which they secure. The

company must pay this debt in any event. Why not allow these securities to be sold and thus obtain the means of liquidation? This method for paying floating debt has never, in hardly any important reorganization, been so much as considered. On the other hand, the road always regains possession of these collaterals by paying its debts with funds raised in some other manner, and redeposits them in its treasury. In only one important instance do we find the plan of selling collaterals to have been adopted. The Baltimore & Ohio Railroad in 1896 sold $3,500,000 of securities which it held in its treasury to raise a part of the cash required in its reorganization. This case offers an explanation of its exceptional nature, and shows why other roads did not pursue the same policy. The greater part of these collateral securities consisted of Western Union Telegraph stock acquired some years before in exchange for telegraph interests of the Baltimore & Ohio Railroad. These securities, therefore, represented a "clear asset" of the railroad company, an asset, that is to say, the possession of which was in no way essential to the integrity of the system, and the loss of which would not diminish its earning power. Such property as this would naturally be sold as the most available means to raise money. Nor could the creditors fairly object should the court authorize such a sale. "Clear assets" such as these, form no part of the security of the bonds, and could be sold for the benefit of the stockholders—the real owners as yet of the bankrupt road—without in any way decreasing the value of their bonds. In such a case as that presented by the Baltimore & Ohio, securities which are the property of the road can be sold to obtain the funds required for the reorganization. But collaterals, as a rule, are not "clear assets." They are the bonds and stocks of branch railroads and various subsidiary companies which are component parts of the general system, and directly contribute to its earnings. It would be both unwise and unlawful to sell them for the payment of the floating debt.

It would be unwise because, deprived of its branch lines and subsidiary companies, the road would be seriously crippled by the loss of the long-haul business contributed to it by these feeders. These branch lines, moreover, might be acquired by its stronger rivals at a time when the market value was low, and the position of competing roads might thereby be strengthened at the expense of the system from whom these feeders had been taken. The sale of these collaterals would furthermore be inequitable and actually unlawful. It would be inequitable because it would impair the security of all the bonds which is the capitalized value of the net earnings essentially of the entire system. These bonds, moreover, may have been bought by their present holders at prices increased by the improved security which these feeders had furnished. Such a sale is, moreover, unlawful, because branch lines and subsidiary companies are expressly covered by some mortgage and could not be sold for the benefit of any but the holders of the bonds which they secured.

Cut off from the recourse of the ordinary bankrupt, the bankrupt railroad which is struggling toward the surface has first resort to assessment upon stockholders. The stockholders, so it is commonly held, are the risk takers. They receive the extra profits, and it is but just that they should bear the brunt of the loss. The stockholder is, in the common run of opinion, the entrepreneur, the active man of business, who is in position to take advantage of the extra gains of prosperity, and who should now be willing to shoulder the burden of calamity and misfortune. This view of the case does not describe the real situation. The stockholder has, through his representatives, placed certain mortgages upon his property, agreeing in the terms of the mortgage contract that if the stipulated interest were not paid, the property could be sold for the benefit of the creditors. The contingency provided for in the contract has arrived, and the interest cannot be paid. The stockholder

is now confronted with an alternative. The creditors are willing to forego their rights of purchase—being constrained to this consent through the difficulty of dissolving the system into its component parts—on condition that the floating debt be paid, and the railroad again placed squarely upon its feet. Nay, more, they are willing to consent to a reduction of fixed charges in order that the danger of future bankruptcy may be removed. They demand, however, as a condition of their forbearance, that the stockholders shall provide the cash which is immediately required. If the stockholders can raise the money, they may retain their interest in the road. Failing to do this, they must submit to one of two alternatives, either one of which will destroy the value of their stock. The road may be offered for sale, in which case the bondholders can employ as means of payment their own securities at par value, or the stockholders may resign their rights to other persons who are willing to take the chance offered to the stockholder and, by paying the assessment, become partners in the new company. If the second alternative be accepted, the stock is destroyed. If the stockholders accept the first and compete with the bondholders for the purchase of the road, they must undertake the impossible task of paying in cash the funded and floating debt of the entire system. There can hardly be any choice for the stockholder. The assessment which he is called upon to pay, taken in connection with the value of the shares in the new company which he receives in exchange for his old stock, more especially when the ultimate value of those shares is considered, shows a negative profit to be made by paying the assessment asked of him—that is to say, if he does not pay the assessment his loss will be absolute, his stock will be "wiped out"; while if he pays, there will be something left for him in the present, and the prospect of yet greater things in the future. Let us consider the situation of the stockholder who is considering an assessment proposition. In the plan for reorganizing the

Northern Pacific, it was proposed to assess the preferred stock $10 per share, and the common stock, as befitted its inferior position, a larger amount, $15 per share. On paying this assessment and depositing the stock, holders would be entitled to receive stock in the new company in the following proportions: Holders of preferred stock in the Northern Pacific Railroad Company, in return for 100 shares deposited, would receive fifty shares of preferred and fifty shares of common stock in the new Northern Pacific Railway Company; and common stockholders would receive share for share to the amount deposited in common stock of the new company. In order to judge of the attractiveness of this proposition, we must consider the value of the stock before and after reorganization, subtracting from the former figures the amounts of the assessments. The result appears in the following table:

	Value of Northern Pacific Stock December, 1895.	Less amount of Assessment, $15 common, $10 preferred.	Value of New Stock issued in exchange for disturbed securities, December, 1896.	Net Gain by Assessment.
Common . .	3 — 4⅜	—6⅜	12½—15⅛	7⅝
Preferred . .	10⅞—16	—1⅝	21⅝—25¼	21 13-16

The gain to the stockholder from paying the assessment is plain. If he did not pay it, his stock would be destroyed. Having paid the assessment, however, although for the moment this made his shares worth less than nothing, yet the stock of the new company which he received bore so high a value within a year, that instead of having nothing, the preferred stockholder had a security worth $23 7-16 and a common stockholder one of $13¾. When we allow for the amount of the assessment and the value of the old stock, the net gain to the preferred stockholder is $19⅜ per share, and to the holders of common stock $7⅝. Reorganizations take place in times of depression, when traffic and earnings are at the lowest point and when the values of all securities have greatly declined from usual figures. It is a practical

certainty that the stock which, before reorganization, is not worth five cents on the dollar, and which has not paid a dividend for years, when the road has been reorganized, its management renovated, and its physical condition so improved that it can take care of all business which is offered, will bear a much higher value than at the time of reorganization, and may even pay a respectable dividend.

With the prospect of reviving business, and with the certainty of a larger and more stable traffic to result from the permanent development of the country, the stockholder has every inducement to raise the money required for the assessment within the time fixed by the committee and agreed to by the bondholders. Take, for example, the case just mentioned of the Northern Pacific. The common stock, which, in December, 1896, was worth only 13¾, three years later, in December, 1899, was worth nearly four times that amount, or 52 5-16, while the value of the preferred stock had increased during the same period from 22 7-16 to 73 1-16. The Atchison stock, which paid a heavy assessment in 1895, shows the same upward movement. In January, 1896, just after the reorganization had been completed, the common stock sold for 14⅝, and the preferred stock for 21⅝. In December, 1899, the value of the common stock was 20 3-16, and the value of the preferred 60⅛. The stockholders of the bankrupt roads make no mistake when they rely upon the future to reimburse them for their sacrifices in the present. The time and manner of payment is made easy for them. Reorganization assessments are usually made payable in several instalments, extending over a considerable period which gives ample opportunity to the stockholders to raise the money required of them. There is seldom a disposition on the part of bondholders to "freeze" them out of the road or to destroy the value of their holdings. All they demand is that the security of their bonds should be made good by the rehabilitation of the property and the payment of its floating debt. If this is done, they are

willing that the stockholders should retain their interests in the property, not, however, without the check and control imposed by certain limitations and restraints which will be presently dealt with. In the majority of cases the assessments are fully paid. In the Erie reorganization of 1878, for example, only 9,542 shares out of 105,796 failed to pay their assessment. It must not be understood, however, that the original purchasers of the stock are, in the majority of cases, those who pay the assessment. Most of the small holders have long since sold their shares for what they would bring, and the purchasers are that class of capitalists who can command the amount of ready money necessary to take care of the bargains. Most of those stockholders who have not sold on the decline are squeezed out by the assessment, so that the stock which pays the assessment is in different hands from those where it originally belonged.

In rare cases, the junior bondholders have also been asked to pay an assessment. This practice, now almost universally abandoned, was formerly much in vogue. Its injustice was apparent. The junior bondholder is not a partner of the road—he is its creditor. Unless its affairs have got into a frightful state of demoralization, the greater part of his interest has been earned. Indeed, it may all have been earned, but diverted through a receivership to other purposes than interest payment. Under these circumstances, there is, as will be pointed out, good ground for changing the character of the security of the junior bondholder, but there is no warrant whatever, save in the most exceptional cases, for treating him as the stockholder is treated, and requiring him to pay a cash assessment. Sometimes, however, there is no alternative. The reorganization committee of the Atchison, Topeka & Santa Fe Railroad thus explained the necessity of levying an assessment upon the junior bondholders:

"The 4 per cent assessment is a necessity for the following reasons:

"About $14,000,000 cash has been raised to pay off the floating in-

debtedness of the company and for other purposes. The stockholders, in the ordinary course, should provide the whole of this amount, but in case they should fail to do so, the second mortgage bondholders would themselves have to provide the whole of it, in order to preserve their hold npon the property.

"It was therefore deemed to be in the interest of the second mortgage bondholders to divide the burden of this $14,000,000 between them and the stockholders.

"The proportion of the assessment that would be borne by the stockholders could only be gauged by the amount of assessment that they would be willing to pay in order to protect their rights. This amount is believed to be $10 per share, and it is necessary that the second mortgage bondholders shall provide the remaining $4 for their own protection."

There is no answer to this reasoning, and the way of escape from the assessment which it offers is really no permanent advantage to the second mortgage bondholders, who by paying the assessment will receive preferred stock for the assessment. This alternative is the one already suggested. A large issue of first mortgage bonds could have been made, and the funds required could have been raised by selling them below the market price to a bond syndicate, but this would have increased the fixed charges upon net earnings to the amount of the interest on this extra issue, and would have shoved in this interest ahead of the second mortgage bonds. As between increasing the fixed charges, and assessing the second mortgage bondholders, the second course appears to be the wiser.

The Underwriting Syndicate.

Although the stockholders' interest points to the acceptance of these conditions, and although the assessment is generally paid, still there is always the chance of failure, either from a general unwillingness on the part of the stockholder to accept the terms offered, in the hope of getting more favorable treatment, or from the inability of some stockholders to raise the required amount within

the time allotted for the deposit of their securities. It is of the utmost importance that the plan of reorganization, prepared with great care, and assented to by conflicting interests only, it may be, after a long struggle and much higgling, shall be carried through to a successful termination. Should the plan fail, the weary work must be done all over again, and the difficulty of perfecting a second plan is much increased by the unfavorable effect produced by the failure of the first. To guard against such a contingency, and at the same time to bring pressure to bear upon the stockholder by showing him that others stand ready to accept the terms which are first offered to him, the underwriting syndicate has been made a feature of all the later reorganizations. The underwriters of a new company agree to "finance" it, that is, to furnish all the money which may be required for its formation. Underwriting may involve an absolute or conditional agreement. The underwriters may either expressly agree to purchase a certain amount of securities outright, or they may merely guarantee the success of the various assessments and adjustments which are relied upon to furnish the funds required. As a rule, the two methods of underwriting are combined. The assessment upon stockholders cannot always be relied upon to furnish the necessary amount, especially if a large sum is immediately demanded. For example, the amount of cash to be raised for the reorganization of the Baltimore & Ohio Railroad was $36,092,500, and the total amount of assessment upon the $5,000,000 of preferred and $25,000,000 of common stock was only $5,460,000. As already noted, $3,500,000 was to be raised by the sale of Western Union Telegraph stock, but even this left the committee $27,132,000 short of the necessary amount which was raised by the sale of a part of the new issue to a syndicate, leaving so much less to be given in exchange to the holders of the old stock and bonds. This is an extreme case, but in almost every reorganization some cash must be provided by the under-

writers. The method is thus described in the Erie circular of 1895: "A syndicate of $25,000,000 in money has been formed to subscribe to $15,000,000 of the prior lien bonds of the new company, and to take the place and succeed to the rights of holders of preferred and common stock of the New York, Lake Erie & Western who do not deposit their stock and pay the assessments." In this case the cash requirements of the new company were met by the sale of securities and by assessment upon the stockholders. The sale of this amount of prior lien general mortgage bonds to a syndicate necessitated a reduction of the grade of other securities in order to keep the fixed charges well within the estimate of net earnings. [1]

The St. Louis & San Francisco Reorganization Committee made the bondholders of the road its underwriters. Of the $6,841,000 required, $5,500,000 was to be raised by the sale to the bondholders of $5,500,000 of new mortgage bonds and $19,250,000 of stock. For $670 in cash, a bondholder was offered $670 in new mortgage bonds, $469 in first preferred stock, $670 in second preferred stock, and $1,206 in common stock. The ordinary compensation of the underwriters is the margin between the value of the securities at the time of purchase and the value under improved conditions, and this margin, as already noticed, is in the case of some stocks very large. When bonds are purchased, they are usually taken at a substantial fraction below the market price. A stock commission may also be paid. The under-

[1] The Erie plan of reorganization offers an amusing instance of the inducements which can be held out to the stockholder to pay up promptly. Arrangements had already been made with the syndicate to furnish $15,000,000 of the $25,000,000 required. The remaining $10,000,000 was to be raised by an assessment of $8 on the preferred stock and $12 on the common. The managers, however, were able to offer a substantial discount for cash. They stated that the assessment was $12 on the preferred and $18 on the common, "but as prompt deposit of the securities and an early payment of a considerable assessment fund are important, a deduction of $4 per share on the preferred stock and $6 on the common stock will be allowed on account of the assessments above mentioned to such depositors as deposit their stock within a short period discretionary with the committee."—"Commercial and Financial Chronicle," vol. 61, p. 369. This is analogous to the practice of marking up goods before marking them down.

writers of the Union Pacific Reorganization Plan received for their services $6,000,000 in preferred stock, of which $1,000,000 went to the banking house which managed the reorganization. The compensation to reorganization managers where large interests are involved is usually $500,000 or $600,000 exclusive of expenses. The banking firm of J. P. Morgan & Co., during the last few years, have had charge of most of the large operations of this nature.

The Bond Reserve.

In addition to the providing of cash for immediate requirements, the reorganization committee must see to it that the necessary capital for betterments is secured. Each year a large sum should be spent on betterments by every well-managed road. Failure to do this invites disaster. The downfall of most railroads has been assisted by insufficient equipment and poor condition. So far as this expenditure results in an increase in earning power, it may be paid for by an issue of bonds. But an increase of debt is not easy to manage when bondholders have been heavily mulcted by reckless issue of bonds. They are apt to be very cautious in the future, and many reorganization plans during the twenty years preceding 1893, contained an express prohibition against any increase of the funded debt without the consent of a large majority of the bondholders. This consent it was naturally hard to obtain, and some roads were prevented from making the most necessary improvement by the inability to obtain the consent of bondholders to an increase of the debt. In their circular of August 31, 1895, the Reorganization Committee of the Erie Railroad remarked of this prohibition as follows: "The absence of any such provision for capital expenditure has always been one of the chief sources of embarrassment of the Erie system, and has made it imposible for that system to keep up with its competitors, or to adapt itself to handling business with that

economy which the character of its traffic necessitates." In the later reorganizations, the necessity of some provision for increase of capital has been clearly seen. It was, however, necessary, in order to gain the consent of stockholders and junior bondholders, from whom sacrifices were demanded, that they should be protected against the danger of reckless bond issue by the new company. Indeed, this solicitude for the stockholders' interests has been carried to such a length that, so far from conditioning the increase of funded debt upon the consent of the bondholder, it is the stockholder who must sanction an issue of bonds above the amount specified by the plan of reorganization, and in almost every case, two-thirds of the holders of one or both issues of stock must give their consent before any increase of debt can be made. It is necessary, therefore, if provision for necessary capital expenditures is to be made, that some expedient should be adopted which will not disgruntle the stockholder nor the junior bondholder. This expedient has been found in the bond reserve. A certain amount of the first mortgage bonds which are created by the new company, it is provided, shall be held in the treasury, and their issue shall be authorized only to a limited amount each year. Thus, in the plan of reorganization of the Norfolk & Western Railroad, issued March 12, 1896, it was provided that,

"$9,690,436 (of the first consolidated mortgage four per cent bonds) is to be reserved for the construction or acquisition of side tracks, second tracks, branches and equipment, and for other improvements and additions to the property covered by the first consolidated mortgage, and for other requirements of the new company; but such bonds are to be issued only subject to suitable restrictions to be prescribed in the mortgage securing the same, at a rate not exceeding $1,000,000 for each fiscal year after June 30, 1896): it being understood that any portion of such $1,000,000 of bonds remaining unissued in any one fiscal year may be added to the amount that may be issued in subsequent years."

This provision is in the interest of the stockholder, for it insures to the road an ample provision for betterment expen-

diture, while protecting the stockholder against reckless increase of funded debt. The bond reserve, moreover, makes the creation of floating debt largely unnecessary, for the greater number of the objects for which floating debt is created are specifically included in the permission given for a periodical issue of bonds.

Reduction of Fixed Charges.

The needs of the present have now been provided for. The floating debt has been paid, and provision has been made for sufficient capital expenditure to ensure the highest efficiency of operation. The committee on reorganization must now address itself to the more difficult task of reducing fixed charges so that they will come well within a conservative estimate of net earnings. The fixed charges of a railroad may be broadly divided into charges for leases and rentals, and charges for interest. The first can be more easily reduced than the interest charges. So long as a company is solvent, it must live up to its contracts, but a reorganized bankrupt is entirely free from the obligations and agreements of the old company. Bankruptcy has wiped out the old scores, and the new company need assume only such contracts as its organizers consider to be necessary to the success of the road. If a leased line has proved unprofitable, it can be dispensed with, or, if retained, the rental can be reduced. If a traffic agreement has proved unsatisfactory, a new arrangement can be made. If guaranteed interest on a branch line or a coal company has proven to be in excess of its contribution to the earnings of the main system, the interest may be reduced or the guarantee not allowed to stand. The reorganization committee has a free hand. They cannot be held to old agreements. Old contracts have lapsed, and must be renewed by the new company before they become binding against it. For this reason, every reorganization results in freeing the road from a part of its lease-rentals and guar-

antees. The most notable examples of a reduction in mileage by reorganization are furnished by the Wabash, with a reduction of 1,541 miles, and by the Richmond & West Point Terminal 4,479 miles. These cases are paralleled by the Atchison, which released the Atlantic & Pacific Railroad in its reorganization of 1895, and by the Reading, which abandoned the Central of New Jersey in 1892 and the Lehigh Valley in 1893. A more common method than the reduction of mileage, however, is the reduction of rentals. The owners of the leased line have usually no choice but to accede to the propositions of the reorganization committee for a reduction of charges. Their property is of little value outside of a large railway system, and, as a rule, the system in connection with which it is most valuable, is that with which it is already connected. The result is that the reduction in contracts by reorganization usually takes the form of a decrease of charges rather than a decrease of mileage. The extent of the reduction in rentals from reorganization is seen where the reduction of this item of fixed charges for the entire country is considered. The net reduction in lease rentals from 1892 to 1898 was $24,527,000, and of this sum $17,768,000 appears in the South and West where the failures were most numerous and extensive. The reductions of rentals are most conspicuous in the Northwest and Pacific coast railroads. It is true that a part of this decrease in rentals is to be ascribed to the steady movement in the direction of consolidation which is constantly converting lease into purchase, but coming so close together, the difference between the figures of 1892 and those of 1898 is sufficiently marked to warrant the conclusion that most of the reduction is due to the numerous reorganizations which intervened.

Reduction of Interest.

We come now to the most difficult part of the task which the reorganization committee have set themselves. The holders of some of the bonds must make sacrifices.

Although, according to the letter of the mortgage contract, they are secured by specific pieces of property, yet, as a matter of fact, this separate security is worthless,—they must all stand together if the earning power of the road is to be maintained. This being the case, what bonds shall be disturbed, in what way shall their claim be reduced, and what compensation shall be given? Let us reverse the inquiry and ask what are the bonds which are not disturbed? In every reorganization we find some of these bonds. Take the Erie road, for example. It has five divisional mortgages made on portions of the line which lie within the State of New York. These mortgages have survived three reorganizations, not being disturbed by any of them. In the same way the Norfolk & Western, the Reading, and the Baltimore & Ohio each carried over certain issues of bonds without in any way disturbing them further than in some cases to change their name by exchanging them into other securities of equal value. These bonds are passed by in the reorganization for the reason that their interest, even in the worst years, has been fully earned. Divisional bonds of important branch roads and first mortgage bonds of larger systems, not to forget terminal bonds, do not suffer for the reason that there is no way to get at them. The property which secures them, such, for example, as a terminal or a connecting link in a trunk line, cannot be dispensed with. Should the holders of these bonds force a foreclosure, they would dissolve the entire system. Moreover, since their interest has been fully earned in the contribution of their security to the general earnings, the courts would undoubtedly protect them against any attempt to reduce the amount of the principal or interest. It is common, however, to find that branch lines have not earned the interest on the bonds, even when allowance has been made for their contribution to the traffic of the main line. In such cases, divisional bonds fare no better than junior liens. For example, in the Norfolk & Western reorganization of 1895, several branch

line issues were partially converted into preferred stock. It is only an absolute first lien that can feel secure in a reorganization. First mortgage consolidated bonds have not been so fortunate. Their lien is subject to divisional mortgages which may easily, in bad years, so diminish the net earnings as to cut into the interest on the general mortgage. The Reorganization Committee of the Atchison, in their circular of 1895, took the following position with reference to the general mortgage bonds:

"After making a careful estimate as to how much of the existing lines, if retained in the system, could, under the circumstances, be avoided, or, if these lines be left out, what amount the Atchison system would be able to earn without the auxiliary lines, the committee has arrived at the conclusion that it would not be safe to place upon the property a fixed charge of more than four per cent upon seventy-five per cent of the principal of the present general mortgage bonds."

The situation of holders of general mortgage bonds in a reorganization is exactly stated by the committee. The road cannot earn their interest. They cannot, in reason, refuse to consent to a reduction of their claim to fixed income. Suppose they should refuse, what can they do about it? The only alternative is to foreclose the mortgage. To do this they must raise enough cash to pay off all the prior liens, for their mortgage is spread over and is subordinate to a large number of claims superior to their own. This is practically impossible, so the only course is to submit or hold out for better terms. It is true that there is always the final resort to the courts, who may, at any time before the recording of the new securities, hold up the whole proceeding by injunction, and that will be done if it can be shown to the satisfaction of the court that any interest is being unjustly treated. Such interference, however, cannot, unless in cases of the most flagrant injustice, be secured by a minority. If a large majority of the bonds are deposited, the courts will usually refuse to interfere, holding that the

consent of the majority should be binding upon all. The contest over the Erie reorganization offers an illustration. A plan had been proposed which seemed unfair to the second mortgage bondholders. Nevertheless 80 per cent of these bonds had been deposited when a suit was brought in the New York Superior Court to enjoin the company from recording the mortgage. The court refused to grant the injunction on the ground that the consent of so large a majority of the parties in interest had made the plan already operative. The disturbance of first mortgage bonds was far more common in the early reorganizations, the reason being that their security at that time was much inferior to what it subsequently became. The first mortgage bonds of the Northern Pacific in 1876 were converted into preferred stock. The first mortgage bonds of the West Shore in 1885 were reduced in amount 50 per cent. The first mortgage consolidated bonds of the East Tennessee, Virginia & Georgia in 1885 were reduced 40 per cent. Arrangements even more unfavorable to bondholders were not uncommon in the early period, and indeed, generally speaking, the bondholders of weak roads must always make heavy concessions. For example, in 1873, the first mortgage bonds of the New York, Ontario & Western were converted into the common stock of the new company at par, and the second mortgage bondholders had to pay 20 per cent in cash for a similar privilege. In the reorganization of the Cincinnati, Wabash & Michigan, in 1880, the bonds received 70 per cent in stock. A method for dealing with bondholders, formerly in common use, was to require them to fund their interest in bonds of the same issue, or to convert it into inferior securities. In the reorganization of the Chesapeake & Ohio, in 1876, $15,000,000 of first mortgage bonds were issued in exchange for the bonds of the old company, with coupons payable for three years in preferred stock, and the second mortgage coupons were made payable for six years in preferred stock. The Erie reorganization plan of 1878

contained a similar provision. Absolute reductions of interest, without compensation in inferior securities, were also not uncommon. Witness the reduction of interest from 6 and 7 per cent to 5 per cent on the Eastern Division bonds. The position of the first mortgage bondholder, however, whether his security be a prior lien or consolidated mortgage, has steadily improved with the general increase in net earnings, and, as already remarked, in the later reorganizations he has been but slightly disturbed in comparison with the losses which he suffered in the period preceding 1893.

The reorganization committee, since they have no claim upon the first mortgage bonds, turn to the junior mortgages and the debenture and income bonds whose interest has not been fully earned. The former position of the junior bondholder was anomalous. He held a claim for a fixed rate of return which would not at all times be paid from the net earnings. This claim was nominally secured by property, but really by revenues—and a revenue inadequate to the payment of interest implies an impaired security. His bond, therefore, was no bond at all, because the distinguishing characteristic of a bond is the power which it gives to enforce its own payment by the sale of the property which secures it, and this it was not possible for the junior bondholder to do. He had, it may be, already discounted the greater risk of an inferior lien in the lower price paid for his bond, thus obtaining for 15 or 20 per cent less than the buyer of a first mortgage bond the same nominal claim to a fixed rate of return. As a matter of fact, the very discount at which the junior bonds were sold indicated that their interest was not fixed, but conditioned on earnings; in other words, that the bond was no bond at all, but rather a claim to a share in profits on practically the same basis as the stockholders. But, although a claimant upon profits, the junior bondholder acted as though his contract was in reality binding and his bond perfectly secured. As a result of his attitude one-third of the railway mileage of the United States has

been at one time in the hands of a receiver, thrown into actual bankruptcy, as though the junior bondholders were really able to enforce a full recognition of the claim upon properties which could not sell for the par value of the bonds outstanding against them. Then, when these bankrupt roads came to be reorganized, it was very soon found that something could not be made out of nothing, and the junior bondholders were obliged to accept the situation and reduce their claims to manageable limits. It has taken thirty years to drive this basal fact into the minds of investors—that a charge is not fixed when it is not at all times earned, and that when its earnings are insufficient to pay the interest on bonds the property can by no possibility sell for enough to pay their principal. The first step in the education of the bondholder was to give him income bonds in exchange for his second and third mortgage bonds, which were very common before 1880, but which have practically disappeared from the bond lists since that time.

It will be worth while to examine in some detail the terms and provisions of an income or debenture mortgage and to note the inconsistency which it involved. The form of an income mortgage contract was in general not different from other mortgages. The indenture was duly made out to a trustee to whom the railroad company acknowledged itself indebted in the sum of $1,000, which was to be paid at some distant date, place, time and manner of payment being carefully set down. Furthermore, the railroad company promises, I use the language of the Richmond & Danville debenture mortgage of 1883,

"as interest upon the principal of this bond, such sum, not exceeding 6 per cent per annum, as shall remain out of net earnings of the company in each year, after paying the interest upon all bonds secured upon existing liens upon its property, the rental of all property now leased by the said company and its operating expenses. In its operating expenses shall be included expenditures made for the repair, renewal and improvement of its existing property, as well as

for purchases or construction of additional property and equipment necessary for the proper conduct of its business. The amount of interest to be paid in each year shall be determined by the board of directors."

The powers and duties of the trustee in case of foreclosure were also gravely set down. "But if default shall be made in the payment of the principal of any of the said bonds at maturity, and such default shall continue, etc.,—or if default shall be made in the payment of interest upon any of the said bonds, when earned and declared in accordance with the terms and conditions of said bonds, and such default shall continue for the period of ninety days—after the same shall have been ordered by the board of directors of the said company to be paid, etc., then the said Central Trust Company of New York shall have the right, the written request of one-fourth in amount of said bonds—to enter upon and take possession of the railroad's property, etc." As a piece of unconscious humor, this can hardly be surpassed. Notice the general incongruity of the thing. To begin with, the so-called interest is in plain reality no interest at all, but merely a dividend to be declared by the board of directors after paying all such charges and making such repairs and improvements as they consider necessary for the welfare of the property. Observe the wording—"What remains shall go to the income bondholder." In short, he is the residual claimant. He receives profits and bears losses. He is, to every intent, a stockholder, except that he has no voting power, no share in choosing the board of directors who are to decide whether he shall get something or nothing. He is, to this extent, in a worse position than the stockholder who can exert some influence upon the policy of the road. Furthermore, his right of foreclosure is as flimsy as his claim to fixed income. If the board of directors shall declare that a certain sum is owing to income bondholders, if they shall order that sum to be paid, and then if, through some extraordinary

mishap, the money be not forthcoming, for it is to be presumed that the board would have the money in hand before they declared it payable—only in this improbable event, can the trustee of an income mortgage force the road into bankruptcy. The security of the income bondholder is the willingness of a board of directors which he has had no share in choosing, to pay over to him sums of money which they have a perfect right to expend on the improvement of the property, a task which is never completed. In other words, the security of the bondholder is no security at all. He has no means of compelling directors to pay him his interest, for the courts have repeatedly held that the determination of the amount of "net earnings" was the exclusive prerogative of the board of directors on the ground that they were the proper persons to decide how much should be spent upon the betterment of the road. It is not surprising, therefore, to find that out of twenty-nine series of income bonds listed on the New York Stock Exchange Investment Supplement in 1890, only six paid any interest, and that of these twenty-nine issues, aggregating $308,802,000, eighteen issues have since disappeared, while those which remain, with one or two exceptions, are confined to the investment roads, whose policy it has always been to live up to the spirit of the contracts and whose earnings have enabled them to maintain that policy.

After the second and third mortgage bonds had been converted into income bonds, thus relieving the roads of a large part of their fixed charges, the necessities of the railway manager created a new form of security which was equally untrustworthy, but which the magic of the word "bond" enabled him to sell in large amounts. This was the consolidated or "blanket" mortgage, spread over the swarm of prior liens who, under its friendly shelter, got to their own share the larger part of the income of the road. These general mortgages, in the splendor of their comprehensiveness, impressed the minds of the investing public,

and brought quite good prices—prices approaching those of prior lien bonds, to which, of course, in point of real security, they were vastly inferior. The consolidated mortgage came in after everything else had been paid, and the principle on which it was issued was the unfamiliar axiom that the whole is not equal to but greater than the sum of its parts. Here was a railway system formed by a consolidation of a number of railroad, terminal, and subsidiary companies of various kinds, each one being subject to mortgage liens up to the point of safety—liens whose amounts were graduated according to the degree of contribution by each part, to the general earnings of the whole. The road was, therefore, before the creation of the general mortgage, bonded up to the limit of absolute security, and in many cases, somewhat beyond it. Nevertheless, the imposing structure of a general mortgage, a "first mortgage," be it noted, that is to say, the first of its kind—was built upon a foundation which was ready to cave in and topple down the whole edifice at the first shudder of business depression. Almost every large failure of the period 1893–1896 involved one or more consolidated mortgages, and the defaults of 1884–1886 were also, in most cases, made upon this class of securities. These general mortgage bonds were claims upon profits, and not, in the real sense of the term, claims to fixed rates of return. In flush times, their interest could be paid. In periods of depression, the company must default on its consolidated mortgages, and, fearing foreclosure, go into the hands of a receiver until the real status of its various securities could be determined by a committee of reorganization. The consolidated mortgage bondholder, just as his predecessors of the second and third mortgages, had to be disillusionized and shown what was his real position. This has been done in the reorganizations of the last few years. Besides income bonds and consolidated mortgage bonds, there were the few important instances of default on first mortgages, and the more numerous cases of default on

branch lines to be dealt with by the reorganization committees of 1893–1896.

The principle adopted for dealing with this problem was as simple as it was satisfactory. The net earnings of the road were taken as the measure of fixed charges. The reorganization committee apportioned the net earnings among the various disturbed securities according to the amount that each was judged to have contributed to the net earnings. In so far as the interest on a bond had been earned, its absolute lien was retained. In so far as its interest had not been earned, it was reduced to its true position as a portion of the capital stock, an investment whose return is not guaranteed but is conditioned on the earnings of the system. The results of the apportionment are illustrated in the following tables, which show the basis of exchange of two of the most important among recent reorganizations, the Northern Pacific and the Norfolk & Western:

I. BASIS OF EXCHANGE OF THE SECURITIES OF THE NORTHERN PACIFIC RAILROAD IN THE REORGANIZATION OF 1896.

NAME OF SECURITY.	Cash. Per Cent.	New Prior Lien Mortgage Bonds. Per Cent.	New General Lien Mortgage Bonds. Per Cent.	Preferred Stock Trust Certificates. Per Cent.	Common Stock Trust Certificates. Per Cent.
General first mortgage bonds	3	135	. .	. .	. .
General second mortgage bonds	4	118½	. .	50	. .
General third mortgage bonds	3	. .	118½	50	. .
Dividend certificates	3	. .	118	50	. .
Consolidated mortgage bonds	1½	. .	66½	62½	. .
Collateral trust notes	. .	100	. .	20	. .
Northwest equipment stock	100	. .	. .	. .	. .
Depositors of preferred stock on payment of $10 per share	. .	. .	. .	50	50
Depositors of common stock on payment of $15 per share	. .	. .	. .	. .	100

II. BASIS OF EXCHANGE OF THE SECURITIES OF THE NORFOLK & WESTERN RAILWAY IN THE REORGANIZATION OF 1896.

NAME OF SECURITY.	Cash. Per Cent.	First Consolidated Mortgage Bonds. Per Cent.	Preferred Stock. Per Cent.	Common Stock. Per Cent.
Adjustment mortgage, 7 per cent bonds	7	130	20	. .
One hundred year mortgage bonds	. .	62½	75	. .
Maryland and Washington Division bonds	. .	70	67½	. .
Chester Valley Division bonds	. .	50	70	. .
Equipment mortgage bonds, 1888	. .	100	48	. .
Five hundred and ninety debentures of 1892	. .	. .	100	. .
Roanoke and Southern Railway bonds	. .	55	65	. .
Lynchburg and Durham Railway bonds	. .	35	65	. .
Norfolk and Western common (Assessment $12.50 per share)	. .	. .	. .	75
Norfolk and Western preferred (Assessment $12.50 per share)	. .	. .	. .	112½
Roanoke and Southern Stock (Assessment $12.50 per share)	. .	. .	. .	75
Lynchburg and Durham Stock (Assessment $12.50 per share)	. .	. .	. .	75

It is not required to go deeply into the analysis of these self-explanatory tables. In brief, it may be said that in so far as the specific security of each bond had earned its fixed charges, to that extent it was exchanged for new mortgage bonds. In so far as its interest had not been earned, and in general for the huge mass of incomes and debentures, preferred stock was given usually to an amount greater than the par value of the securities which they displaced. This principle of apportionment is especially well illustrated in the Norfolk & Western reorganization. The bonds of four branch roads were disturbed. Of these, the Maryland & Washington and Roanoke & Southern had earned more than the other two, and the greater earning ability was recognized in a large proportion of preferred stock. The 100-year mortgage bonds also, whose interest had not been fully earned, were cut down 25 per cent, but 55 per cent in

first preferred stock was given in exchange, so that in the long run the bondholders were no losers, the preferred stock in 1898 having sold for 63⅞. In the same way, the consolidated mortgage of the Northern Pacific received 62½ per cent in new prior lien bonds and 62½ per cent in preferred stock. In 1895, before the reorganization, the consolidated bonds did not rise above 36, while in December, 1898, two years after the reorganization, the prior lien bonds sold for 103 and the preferred stock for 78. In exchange for a bond worth $360, the Northern Pacific bondholders received another bond worth $643, besides $780 in preferred stock.

The extent to which conversion of junior bonds into preferred stock has gone appears from the following table, which shows the amounts of preferred stock issued for various purposes by eight of the largest reorganizations since 1893.

NAME OF ROAD.	Amounts of Preferred Stock Issued.			
	For Old Bonds.	For Stock.	For Assessments.	Miscellaneous.
Atchison, Topeka and Santa Fe	$96,740,000	......	$13,717,000	$9,200,000
Erie — First preferred	27,146,000	$8,537,000	....	2,854,000
Erie — Second preferred	7,271,000		.....	192,000
Norfolk and Western	22,833,000	.....	......	167,000
Northern Pacific	54,880,000	17,620,000	......	2,500,000
Oregon Railway and Navigation Company	9,290,000	......	1,440,000	270,000
Reading — First preferred	7,184,000	......	......	20,816,000
Reading — Second preferred	40,286,000	......	.....	1,714,000
St. Louis and San Francisco — First preferred	8,214,000	......	1,150,000,	3,850,000
St. Louis and San Francisco — Second preferred	8,214,000	......	......	7,786,000
Southern Railway	32,887,000	8,799,000	7,814,000	4,800,000
Totals	$314,945,000	$34,956,000	$24,121,000	$54,149,000

A share of preferred stock entitles its holder to receive a specified rate of return before any dividend is declared on the common stock. The exact wording of the contract is expressed in the contract of the Northern Pacific Railroad with its stockholders:

"Preferred stock is entitled to non-cumulative dividends to the extent of four per cent per annum, payable quarterly out of the net

earnings before any dividends for the year shall be declared on the common stock." If the preferred stock is made cumulative, as was formally not uncommon, the following provision was commonly inserted: " . . . and in case said dividends cannot be regularly earned and paid, as above stipulated, all arrears are to be paid as soon and as fast as the net income of the company will allow, and no dividend is to be made on the general stock of the company until all such arrears have been paid."

Such a provision amounts to a destruction of the common stock, which could have little value if all deficiencies in preferred dividends had to be made good at its expense. Accordingly, a more recent practice has favored non-cumulative provisions. It is not uncommon for the preferred and common stock to share equally in all dividends over and above the stipulated payments to the preferred.

It is also to be noted that the dividends on the preferred stock are payable out of "net earnings"—that is to say, after the expenses of operation, repair, betterment and interest on the funded debt have been paid. In other words, the fixed charge of a mortgage bond whose payment may be enforced by foreclosure, and the anomalous claim of the income bond which had been thoroughly discredited, were converted into a claim for return whose rate is conditioned upon the net earnings of the road. A fixed charge has been converted into a claim upon profits. In the exchange of these so-called "bonds," for stock in the reorganized company, the relation of the quondam creditors to the property is precisely defined, and the element of risk which he assumed when he purchased his consolidated or debenture bond finds expression in the language of the contract which sets forth his relation to the road. The position of the junior bondholder, considered from the standpoint of his own interest, has been vastly improved—whereas before, he was subject to great risk of default without an adequate remedy or protection. The income bondholder, in case of non-payment of his interest, had no recourse whatever, and the junior mortgage bondholder gained nothing by foreclosure. As a

preferred stockholder, however, he has the right to assist in directing the policy of the road, and he can blame only untoward circumstances if all does not go well with him. Moreover, there is the further inducement offered of a larger amount of preferred stock than the par of the bonds for which the preferred stock is given. If the bondholder is not satisfied with the arrangement, he has only to begin foreclosure proceedings to see how helpless is his position. There are but few cases on record, if we except such instances of attempted exploitation as that offered by the Texas Pacific in 1886, or the Wabash in the same year, where junior bondholders failed to see the advantages of the plan proposed as set forth by their representatives, and without delay deposit their securities.

The Voting Trust.

One more feature of recent reorganizations demands attention, and this is the securing of the control of the road for a term of years by a voting trust, elected by the bondholders or their representatives, the mortgage trustees, usually, indeed, by the latter. Thus the plan of reorganization of the Reading Railroad, issued 1895, contains the following provision:

> "The stock shall be held by the voting trustees and their successors jointly . . . for five years and for such further period (if any) as shall elapse before the first preferred stock shall have received four per cent cash dividend per annum for two consecutive years, although the voting trustees may, at their discretion, deliver the stock at any earlier date. Until delivery of stock is made by the voting trustees, they shall issue certificates of beneficial interest entitling the registered holders to receive, at the time therein provided, the number of shares stated, and in the meanwhile to receive payments equal to the dividends collected by the voting trustees upon the number of shares therein stated, which shares, however, with the voting power thereon shall be vested in the voting trustees until the stock shall become deliverable."

As just remarked, the voting trustees are usually named by the mortgage trustees, in most cases by the banking firm which carries through the reorganization. In a few in-

stances, however, the bondholders themselves may elect the trustees. This practice has now practically disappeared, the difficulty of getting a vote from the scattered bondholders being too great.

The purpose of the voting trust is to secure to the bondholders or the representatives, the control of the reorganized property against the attempt of outsiders to get possession of the road by buying a majority of the low-priced stock. This practice was formerly common. Mr. Henry Villard in this way secured control of the North Pacific in 1880, and Mr. Jay Gould several times captured a railroad by this method. Such exploits were usually detrimental to bondholders, who may soon have another series of defaults to suffer and a large floating debt to take care of. It was to guard against the danger of wrecking that the voting trust was devised. The Erie Voting Trust of 1878 was among the first instances of this institution. In the recent reorganizations, it is an almost universal feature. Until the stock has been raised to an investment level, so that it will be purchased not for speculative manipulation, but for investment, until, in other words, the stockholder has an equal interest with the bondholder, in the conservative and economical operation of the property, the bondholders, to protect their own interest, very wisely retain control through a voting trust. There is no organized action of bondholders in the matter. The bonds are too widely scattered for that, but the holders are entirely willing that a banking house or trust company, of high repute, who are themselves large holders of railway bonds, should have the duty of safeguarding their security until all danger from outside manipulation has passed away. The stockholder is actually benefited by this control, which insures the highest efficiency in the management of the property, and the greatest certainty of continued prosperity for all holders of its securities.

The reorganization of American railways is a more noteworthy financial achievement than the payment of the

French indemnity or the refunding of the United States debt. It is noteworthy not merely in the amount of securities involved, but on account of the excellence of the principles which have guided its managers in their action. Its result has made railway bankruptcy a practical impossibility. Railway indebtedness is now well within the limit of railway earnings. The greatest of all financial interests has been placed on a firm and enduring foundation.

EDWARD SHERWOOD MEADE.

University of Pennsylvania.